NATIONAL ECONOMIC
RESEARCH ASSOCIATES
ONE MAIN STREET
CAMBRIDGE, MASSACHUSETTS 02142
TEL 617.621.0444 FAX: *617.621.0336*
INTERNET: *http://www.nera.com*

n/e/r/a
Consulting Economists

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

COMMONWEALTH EDISON COMPANY	:	
	:	
Petition for approval of delivery services tariffs and tariff revisions and residential delivery services implementation plan, and for approval of certain other amendments and additions to its rates, terms, and conditions.	:	No. 01-0423

Surrebuttal Testimony Of

KENNETH GORDON

Filed on behalf of Commonwealth Edison Company

October 24, 2001

ComEd Ex. 44.0

Q1. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Dr. Kenneth Gordon. My business address is One Main Street, Cambridge, Massachusetts 02142.

Q2. HAVE YOU PREVIOUSLY FILED DIRECT AND REBUTTAL TESTIMONIES ON BEHALF OF COMMONWEALTH EDISON COMPANY ("COMED" OR THE "COMPANY") IN THIS PROCEEDING?

A. Yes, I have.

Q3. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. In my direct and rebuttal testimonies in this proceeding, I have discussed why it is important to design delivery service tariffs in a way that supports economic efficiency and that is consistent with the directives of the Illinois Public Utilities Act. This surrebuttal is much more focused, emphasizing where intervenors have missed the boat in their arguments on rebuttal.

This surrebuttal testimony is focused on responding to the rebuttal testimony of Philip R. O'Connor, Ph.D. and Richard Spilky of AES NewEnergy, Inc. (who testify on behalf of the "ARES Coalition"), Peter Lazare and Mike Luth of the Illinois Commerce Commission (the "ICC" or the "Commission") Staff, Edward C. Bodmer (on behalf of the City of Chicago, the Illinois Attorney General's Office, the Cook County State's Attorney's Office, and the Citizens Utility Board), Craig G. Goodman (on behalf of the National Energy Marketers Association), and Marc L. Ulrich of Enron Wholesale Services (on behalf of the "ARES Coalition").

In various ways, these intervenors want to "have their cake and eat it to." As an economist and former regulator, I continue to believe that the Commission must set the Company's delivery services rates in a manner that is consistent with sound economic principles. This is not an easy task—but it is critically important that distribution utilities be allowed a reasonable opportunity to fully recover their costs and that regulators set prices that accommodate efficient competition where formerly regulated markets have been opened to competition.

In the balance of this testimony, I will explain how the testimonies of the witnesses identified above fail to comport with sound economic principles. It is very important that the Commission reject results-oriented efforts to distort competition, which might be good for new service providers wishing the "boost" of a subsidy to enter the market, but that would not be good for consumers or society as a whole.

Q4. VARIOUS INTERVENORS (E.G., DR. O'CONNOR AND MR. SPILKY (P. 2-3) AND MR. ULRICH (P. 6)) EXPRESS CHAGRIN THAT COMED IS SEEKING TO RECOVER ITS COSTS OF PROVIDING DELIVERY SERVICES. DO YOU HAVE ANY COMMENTS?

A. Yes, I do. Even as competition unfolds, the principle that utilities must have a reasonable opportunity to recover their prudent costs of providing utility service remains. A utility's rates must reflect its costs of doing business. Failure to reflect costs in rates will send the wrong signal to utility customers, leading to inefficient consumption of utility products and services.

There is no need to prevent a delivery service provider from having a reasonable opportunity to recover its costs in order to somehow "promote" competition. Nor should a utility's efforts to recover its legitimate costs of doing business in rates be considered to be an effort to raise its competitors' costs. I recognize that ComEd's bundled rates are subject to a price cap, while its unbundled rates are not. ComEd's efforts to adjust its unbundled rates to more appropriately reflect the actual costs of doing business cannot be considered to be "changing the rules of the game."

Q5. ONCE A LINE OF BUSINESS HAS BEEN DIVESTED, DOES IT MAKE ECONOMIC SENSE TO CONTINUE TO ALLOCATE COSTS TO THAT LINE OF BUSINESS?

A. No. It should not be surprising to anyone that divestiture or transfer of assets will result in losses of economies of scope (simply put, divestiture means that less sharing of overhead and similar costs across lines of business will occur). In ComEd's case, once generation was divested, it made no sense whatsoever to continue to allocate joint and common costs to this line of business.

Q6. DR. O'CONNOR AND MR. SPILKY CONTEND THAT THERE IS "AN INTERESTING AND LIKELY REVEALING CONTRADICTION" BETWEEN YOUR TESTIMONY AND THAT OF COMED WITNESS STROBEL. IS THERE SUCH A CONTRADICTION?

A. No. There is no contradiction. Dr. O'Connor and Mr. Spilky argue that there is a "contradiction" between my testimony concerning the inherent subjectivity of cost allocations and the testimony of ComEd Vice Chair, Pamela Strobel, who confirmed that the costs ComEd seeks to recover in this proceeding "are the costs actually incurred by ComEd." (O'Connor/Spilky Rebuttal, p. 55; ComEd Ex. 21.0, pp. 4-5; ComEd Ex. 18.0, p. 7). While it is true that "allocating costs is an inherently subjective and inexact process," as I stated in my earlier testimony in this proceeding (see ComEd Ex. 21.0, p. 5), the "allocation" of these costs in the past to the generating function does not mean that in effect disallowing these costs in this case by continuing a shadow "allocation" to generation—even though the generation assets have been divested or transferred—is reasonable.

Dr. O'Connor and Mr. Spilky simply fail to recognize that once generation assets were divested, economies of scope would be lost, and those lost economies would have to be borne by customers in some fashion—absent a finding that the allocated costs had been imprudently incurred. I am not aware of any evidence that suggests that the disputed costs are not just and reasonable costs of providing delivery service, as the testimony of ComEd Vice Chair Pamela Strobel also indicates. In fact, I stated in my rebuttal testimony that I was not surprised that the transfer of generation "has provided evidence for a more accurate division of costs between generation and delivery services in this case." (ComEd Ex. 21.0, p. 4). I stated that "[i]n this case, ComEd has identified the actual costs that its delivery function will incur." (Id. p. 5) There is nothing in my rebuttal testimony that suggests that recovery of such costs is improper. Rather, I stated that recovery of such costs "should be allowed." (Id.) Similarly, Ms. Strobel states that "[j]ust as it is a critical task of ComEd to deliver reliable service, it is equally critical that ComEd's rates provide it with the revenues to do that." (ComEd Ex 18.0, p. 2).

Nothing in my testimony suggested that a less accurate method of assigning costs should be used where a more economically appropriate method is available. Direct assignment of costs, where possible, inherently is more appropriate than use of an allocator. By segregating the business into separate units, ComEd has been able to directly assign costs to the cost causing activity. Direct assignment is always more economically appropriate than accounting allocations, where it is possible to do so.

Finally, and more fundamentally, nothing in my testimony suggested that an illogical method of allocating costs, which does not reflect the basic fact that generation has been divested or transferred, should be used.

Q7. MR. LAZARE CONTENDS THAT, FOR PURPOSES OF CONTINUITY, GENERAL PLANT AND ADMINISTRATIVE AND GENERAL COSTS SHOULD BE ALLOCATED USING THE LABOR ALLOCATOR APPROVED BY THE COMMISSION IN DOCKET 99-0117, RATHER THAN THE DIRECT ASSIGNMENT METHOD COMED PROPOSES TO USE IN THIS PROCEEDING. (STAFF EX. 21.0, P. 12). DO YOU AGREE?

A. No. Given the important cost-recovery issues that are involved, the mere fact that ComEd lost on this issue the last time around, as pointed out by Mr. Lazare (p. 12), should not result in the continued allocation of costs to lines of businesses that have been divested or transferred. Absent a showing that the costs in question are not appropriately incurred, or that they have been inappropriately assigned to the different classes of customers, the appropriate level of costs should be recovered from the continuing lines of business.

Q8. IS IT REASONABLE TO PROVIDE CREDITS FOR UNBUNDLED SERVICES IN EXCESS OF NET AVOIDED COSTS?

A. No. As I explained in my rebuttal testimony in this proceeding, giving artificially high credits for unbundled services not taken from the utility will lead to inefficient entry, which will be costly to society because it will raise prices for consumers.

Mr. Bodmer remains confused about the role of short-run marginal costs and long-run marginal costs (see p. 27 of his rebuttal testimony), as well as when avoided cost concepts should be used. Several points should be made clear:

(1) It should be no surprise to anyone, even Mr. Lazare (p. 2)), that marginal costs are used to set rates (with appropriate adjustments) while the revenue requirement itself reflects the utility's costs of doing business. Mr. Bodmer's quotation of Professor Vickery (p. 27) reflects this point. It is important to use marginal cost based concepts to design rates in order to provide more efficient price signals, but the difference between marginal costs and the overall revenue requirement must nevertheless be recovered in rates. Of course, for bundled services covered by a price cap, that recovery is subsumed in the price-cap plan itself.

(2) The use of short-run cost or long-run cost depends upon what can be varied. The distinction between long-run and short-run cost is not so much a matter of time frame, but rather will depend on which of the resources that underlie the costs can be avoided in any particular situation. In the "short run," only a few costs can be varied, while in the "long-run" it is likely that more costs, including some costs that are fixed in the short run, can be varied, as the utility begins to reshape its operations. Because ComEd will retain a billing supplier of last resort obligation, however, short-run and long-run avoided costs will tend to be closer together than they would be if ComEd were free to simply abandon the billing business. With respect to unbundled metering and/or billing credits, the calculation should reflect the fact that because the utility will continue to provide these services to the customers it retains, it will not be able to avoid bearing the fixed costs of providing these services and therefore these costs will not be avoided by the utility. Rather than being "results-oriented," as Mr. Lazare argues (pp. 20-21), it is critically important to implement rates using the proper cost concepts.

(3) Despite the comments of Mr. Goodman (pp. 3-4), an avoided cost concept is relevant where a customer departs the incumbent utility and takes service from a competitive supplier of metering or billing services. The customer should receive a credit that reflects the costs that the utility avoids when customers switch to a competitive provider. Once customers depart to take service from competitive providers, then the utility would no longer provide these customers with the billing services provided by the alternative supplier. Because the utility would no longer incur costs to provide billing services to the customer, the utility should provide a credit to the customer that reflects the utility-specific costs that are avoided.

(4) The unbundled credit should be based on the appropriately-specified decremental (marginal) costs that the electric utility avoids as a result of no longer providing an unbundled service directly to its customers that switch to other providers. This is not unfair or anti-competitive, as argued by Mr. Goodman (p. 4), rather, this reflects the sound implementation of economic principles. In contrast, using embedded cost methodologies to artificially enlarge the shopping credit would be an inappropriate effort to "jump start" competition by providing a subsidy to new entrants. If the unbundled credit based on long-run avoided costs ("LRAC") or embedded cost results in a higher credit than would be provided if appropriately-specified utility-specific avoided (decremental) costs were used, new entrants would receive a subsidy. Customers and society would not benefit if this subsidy results in entry by inefficient competitors.

Q9. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.